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MERGERS AND MARKET DOMINANCE

Herbert Hovenkamp

Abstract

Mergers involving dominant firms legitimately receive close scrutiny under the antitrust laws, even if they involve tiny firms. Further, they should be examined closely even in markets that generally exhibit low entry barriers. Many of the so-called “unilateral effects” cases in current merger law are in fact mergers that create dominant firms. The rhetoric of unilateral effects often serves to disguise this fact by presenting the situation as if it involves the ability of a small number of firms (typically two or three) in a much larger market to increase their price to unacceptable levels. In fact, if such a grouping of firms can achieve an unacceptably high price increase for an unacceptable length of time, that grouping is best viewed as a relevant market unto itself.

MERGERS AND MARKET DOMINANCE

Herbert Hovenkamp*

Introduction

No merger threatens to injure competition more than one that immediately changes a market from competitive to monopolized. To be sure, a market that was perfectly competitive before a merger and absolutely monopolized afterward would be a rare thing. If the merger involved only two firms who shared the entire market, that would entail that before the merger occurred, the two were duopolists, and duopoly markets typically perform quite poorly.¹ Nevertheless, the concern with such a merger would be warranted. Even in a duopoly market competition is possible and may

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¹ Indeed, depending on assumptions, output may be no higher, and price no lower, in such a market than it is in an absolute monopoly. For example, if duopolists are behaving as a cartel they would charge the same price and collectively have the same output as a single-firm monopolist.

sometimes be quite robust. Further, new entry into the duopolist's market creates a third firm, while entry into a monopolist's market creates only a second. And the dominant firm permitted to acquire its only rival may do so again and again, thus indefinitely preserving its dominant or monopoly status.

Easy entry; presumptive threshold

Even relatively easy entry should not ordinarily be a defense to a merger creating a monopolist or a dominant firm.² In such a market the existence and growth of a rival is simply too important for competition. The nascent entrant into such a market ordinarily earns only competitive returns, while the dominant firm's returns are far larger. As a result, merging with the dominant firm can often be more profitable to the new entrant than continuing the competitive struggle. Or, to state it another way, for the two firms' owners to share in possible monopoly profits is more profitable than for each to face competition. Of course, if entry is truly easy, the dominant firm will either have to make an ongoing series of acquisitions or its status as the dominant firm will begin to erode.

Thus, when a merger creates a monopolist or dominant firm we would always place on the defendant the burden of showing that entry is so easy that monopoly profits could not be sustained for any significant length of time. We would assess this requirement any time the market share of the post-merger firm exceeds 50 percent.³

² This is particularly the case when markets are defined, as they are in the 1992 Merger Guidelines, to include as "in the market" all firms that are likely to be producing within one year. See 2B Herbert Hovenkamp & Phillip E. Areeda, *Antitrust Law* ¶561d (3d ed. 2008).

³ Such a merger would always exceed the most severe concentration thresholds stated in the Merger Guidelines, with the possibility of an acquisition of a tiny firm—for example, if a 49.99 percent firm acquired a .02 percent firm, the merger would not increase the HHI by the requisite 50 points. In general, however, any merger creating a firm of 42.5 percent or more necessarily produces market concentration exceeding 1800 HHI; and any merger creating a firm of 50 percent or more necessarily produces market concentration exceeding 2500 HHI.

See *United States v. Syufy Enters.*, 903 F.2d 659 (9th Cir. 1990), which refused to condemn an exhibitor's acquisition of competing exhibitors when the immediate market share created was nearly 100 percent but the acquisition was followed almost immediately by entry and dramatic

Dominant Firm's Acquisition of Nascent Rival

The acquisition by an already dominant firm of a new or nascent rival can be just as anticompetitive as a merger to monopoly. If the rival has already made its first sale in the monopolist's market the merger is clearly "horizontal." If the rival has not yet made its first sale, the tendency is to call the acquisition a "potential competition" or nonhorizontal merger.⁴ But the distinction between "actual" and "potential" competition is readily exaggerated. For example, a firm that has submitted bids against the dominant firm but lost is clearly an "actual" competitor, perhaps even forcing the dominant firm to lower its bid in the face of a rival bidder.⁵ But even the firm that is preparing to make its first bid or its first sale must be counted as an "actual" rival once the entry decision has been made.

Acquisition of such a rival preserves the dominant firm's status, at least until another nascent rival appears on the scene. In most such cases we do not believe it is worthwhile to ascertain the number of rivals or the likelihood or time period in which another nascent rival will appear. The important point is that the acquisition eliminates an important route by which competition could have increased in the immediate future. It thus bears a very strong presumption of illegality that should rarely be defeated.

Section 7 of the Clayton Act condemns mergers that may substantially *lessen* competition. By contrast, §2 of the Sherman Act reaches acts that merely "maintain" a monopoly.⁶ While the distinction is easily exaggerated, it should not be lost. Some mergers

expansion reducing the defendant's share to less than 40 percent. The court's only discussion of proof burdens concluded that while the district court had discretion to place the burden of proving easy entry on the defendant after the plaintiff showed sufficiently high concentration, the court was not obliged to shift the burden when easy entry seemed obvious. *Id.* at 664 n.6.

⁴ See 3 Phillip E. Areeda & Herbert Hovenkamp, *Antitrust Law* ¶701d (3d ed. 2008) (acquisition of potential rival as Sherman §2 violation).

⁵ See, e.g., *United States v. El Paso Natural Gas Co.*, 376 U.S. 651 (1964).

⁶ See 4 Phillip E. Areeda and Herbert Hovenkamp, *Antitrust Law* ¶907 (2d ed. 2004), which cites §2 cases.

with potential rivals might be thought not to “lessen” competition at all because they neither reduce the number of rivals in the market nor increase the market share of any firm.⁷ But when the dominant firm in the market has a market share satisfying the Sherman Act §2 standards for monopoly or attempt, a “lessening” of competition is not essential to illegality. Such a merger tends to maintain a monopoly by cutting off an avenue of future competition before it has had a chance to develop. As a result, condemnation under §2 is appropriate.

Possible efficiencies defense⁸

In order for a dominant firm to defend its acquisition of a nascent rival on the basis of claimed efficiencies, it would have to show provable efficiencies that could not be brought about by means other than the merger (i.e., “merger-specific” efficiencies), and that do not result from the creation of a monopoly.⁹ But provable merger-specific efficiencies from the acquisition of a nascent firm should be quite unusual; in most circumstances the dominant firm could readily duplicate anything that the nascent firm has to offer.

The exceptions are (1) when the nascent firm has a new technology protected by the intellectual property laws that the dominant firm can acquire only by acquiring the firm itself; or (2) when the nascent firm has a substantial position in a different market and the efficiencies either result in that market or else from the combination of ownership controlling the two markets.

Regarding the first, suppose that the dominant firm uses a process that costs \$6 per unit but that a tiny rival who has not yet made its first sale in the market develops and patents equally good technology costing only \$4 per unit. Not being able to license the technology, the dominant firm launches a hostile takeover of the tiny

⁷ This is particularly true of the “actual potential entrant” doctrine. See 5 Antitrust Law ¶1121 (2d ed. 2004).

⁸ On the efficiencies defense generally, see 4 & 4A Antitrust Law, Ch. 9E.

⁹ Cf. the 1997 revised statement on efficiencies to the 1992 Horizontal Merger Guidelines, §4.0: “[c]ognizable efficiencies are merger-specific efficiencies that ... do not arise from anticompetitive reductions in output or service.” These Guidelines are reprinted as Appendix A in the Annual Supplement.

firm itself. We would treat this as little different in principle from a patent monopolist's acquisition of an exclusive right in a competing patent at the center of its power,¹⁰ and thus as presumptively unlawful.¹¹ To be sure, the acquisition permits the dominant firm to reduce its production costs, but it does so by eliminating competition between the production alternatives. The most likely reason that this market has a chance of becoming competitive is that the nascent firm has a technology that will enable it to compete successfully with the dominant firm; and nothing prevents the dominant firm from (1) attempting to acquire a nonexclusive license from the nascent firm;¹² or (2) if that effort fails, to develop its own alternative technology.

Regarding the second situation noted above, suppose that a firm is nascent in the dominant firm's market but has a significant position elsewhere, and combining the two firms produces certain efficiencies. For example, in the *El Paso Natural Gas* case¹³ the acquiring firm had significant gas fields in Texas, while Pacific Northwest, the acquired firm, had fields in the northern United States and Canada. Although Pacific Northwest had made bids to southern California purchasers, it had not yet won any bids and thus was not an actual seller there. In such a case the union of the firms could produce significant offsetting efficiencies in the other market.¹⁴ Of course, this raises the problem of the extent to which efficiencies in one market justify anticompetitive results in a different market.¹⁵

IP Acquisitions:

¹⁰ See 3 Phillip E. Areeda & Herbert Hovenkamp, *Antitrust Law* ¶707a, b (2d ed. 2008).

¹¹ As 3 Antitrust Law ¶707d notes, however, an acquisition of a nonexclusive right would be legal.

¹² See the discussion *infra*.

¹³ See *El Paso Natural Gas*, 376 U.S. at 651.

¹⁴ This might occur, for example, if El Paso had substantial facilities in the northern United States as well, and joint operation of the firms' facilities would have reduced costs there. These were not the facts of the actual case.

¹⁵ See 4A Antitrust Law ¶972.

Nonexclusive license or compulsory licensing as solution¹⁶

The discussion of patent acquisitions by monopolists shows that concerns about anticompetitive effects from the dominant firm's acquisition of technology are satisfied by requiring that the dominant firm obtain only a nonexclusive license.¹⁷ The problem is not materially different when the dominant firm seeks to acquire the tiny firm itself rather than its patents or other intellectual property. First, while technology acquisitions can certainly promote efficiencies, a nonexclusive right does so just as well as an exclusive one. Second, if the main concern is that the acquisition threatens to eliminate a rival technology, that threat is taken care of by the nonexclusive license or else by the acquirer's willingness to license all others without royalty—that is, to place the acquired technology in the public domain. To be sure, this may often mean that the acquisition is not worth nearly as much to the acquiring firm, but if the principal value of the acquisition is the dominant firm's maintenance of its technological hegemony, then the only alternative is outright condemnation.¹⁸

Market Delineation in Unilateral Effects Cases

The merger to monopoly and the dominant firm's acquisition of a small or nascent rival both offer measurable injury to competition in the conventional sense of creating or preserving a highly concentrated, presumably anticompetitive market structure. The remaining “unilateral effects” cases seem different in that the aggregate market shares of the merging firms represent a nondominant position in the relevant market as it existed before the merger occurred. Further, the merger does not necessarily facilitate coordinated interaction (collusion or oligopoly) with other firms, as explained in Subchapter 9B-2. For example, one may see situations where a market has ten firms, *A*, *B*, *C*, ... *J*. Firms *B* and *C* then

¹⁶ The same issue arises when the underlying concern is that a large firm's acquisition of a smaller rival's technology might facilitate collusion by forestalling new competition. See 4 Antitrust Law ¶927d3.

¹⁷ See 3 Antitrust Law ¶707g (3d ed.).

¹⁸ See, e.g., *United States v. Baroid Corp.*, 59 Fed. Reg. 2610-01 (1994) (consent decree conditioning acquisition by large firm of competing technology on the granting of licenses to others); *United States v. Westinghouse Elec. Corp.*, 54 Fed. Reg. 8839-02 (1989) (similar).

merge and are able to exact a “significant” price increase for their product notwithstanding the fact that their aggregate share of the premerger market was small, often less than 20 percent. The following observations are relevant:

- A. The primary concern of merger policy is mergers that facilitate the exercise of market power, which is the ability to profit by raising price above one's cost. While market share is a surrogate for market power and widely used in antitrust cases, it is by no means a perfect surrogate.¹⁹
- B. Clayton Act §7 acquires the appraisal of a merger in some “line of commerce” and some “section of the country.” Although this language does not explicitly require a market definition in a merger case, the courts have generally required a market definition.
- C. The economics literature on unilateral effects—and the expert economist conducting empirical tests—often dispenses with a conventional market definition in such cases, preferring to measure market power directly by estimating the change in residual demand facing the post-merger firm. “Residual demand” refers to the demand for a firm's goods after the output of all other competing firms has been taken into account. As a firm's elasticity of residual demand decreases, its power to profit by a price above its cost increases.²⁰ This methodology is quite sensible for the economist, whatever its legal limitations may be.²¹
- D. Literally, the theory of unilateral effects is consistent with condemnation of mergers even in unconcentrated markets. The theory is that by eliminating competition with a “close” rival in a product differentiated market the post-merger firm can profitably raise its price, even though the

¹⁹ See 2B Antitrust Law ¶¶515, 531 (3d ed.).

²⁰ For a brief, nontechnical overview of the methodologies for estimating residual demand, see 2B Antitrust Law ¶521 (3d ed.).

²¹ See Malcolm B. Coate, *Unilateral Effects under the Guidelines: Models, Merits, and Merger Policy* (FTC, working paper, Oct. 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1263474.

balance of the market, containing more remote rivals, remains relatively unconcentrated. As the Government writes in its Commentary on the Merger Guidelines:

Indeed, market concentration may be unimportant under a unilateral effects theory of competitive harm. As discussed in more detail in Chapter 2's discussion of Unilateral Effects, the question in a unilateral effects analysis is whether the merged firm likely would exercise market power absent any coordinated response from rival market incumbents. The concentration of the remainder of the market often has little impact on the answer to that question.²²

- E. One alternative that we do not recommend is a return to *Brown Shoe's* language of "submarkets"—for example, one might say that while the relevant market in the hypothetical market of firms *A, B, C ... J* consists of the sales of these ten firms, a relevant submarket exists for the sales of merging firms *B* and *C*. Historically, the term "submarket" has been used to identify artificially narrow groupings of sales on the basis of noneconomic criteria having little to do with the ability to raise price above cost.²³ After the merger occurs, post-merger firm *BC* can raise its price significantly above cost, thus meeting the usual criteria for market definition and not requiring the confusing "submarket" label. A somewhat better but by no means perfect usage is to say that the merger facilitates the appearance of a new, narrower grouping of sales, or "market," in which firm *BC* occupies a sufficiently strong position so as to enable its price increase. In fact, the merger does not *create* such a market because a cartel of firms *B* and *C* would also have been able to increase price profitably, indicating that *B* and *C* were already a relevant

²² Federal Trade Commission and U.S. Department of Justice, *Commentary on the Horizontal Merger Guidelines* 16 (2006). Available at <http://www.ftc.gov/os/2006/03/CommentaryontheHorizontalMergerGuidelinesMarch2006.pdf>.

²³ See *Brown Shoe Co. v. United States*, 370 U.S. 294, 325 (1962). On misuse of the term "submarket," see 2B Antitrust Law ¶1533 (3d ed.).

market prior to the merger.²⁴ However, before their union *B* and *C* felt one another's competition as well as that of other firms more significantly than after the merger.

In the *Staples* case the court concluded that office superstores" constituted a relevant submarket within a larger market for office supply stores.²⁵ The court cited many indicia, such as recognition by vendors and distinctive formats, which in fact say very little about market boundaries. But most importantly, it noted that superstore pricing was disciplined much more closely by the pricing of other superstores than by that of office supply stores generally. In that case, office superstores were a relevant *market*, and the submarket label adds nothing but confusion.

But to say that a merger of two "superstore" chain would lead to a high price is in principle no different from saying that, while office supply product sellers generally might constitute a relevant market, there is also a smaller relevant market consisting of the superstores themselves, or at least of some more specialized group of large stores. The fact that the superstores charged higher prices in communities where they did not compete with each other than in communities where they did establishes this. It is difficult to avoid the conclusion that if this higher price is higher by an unacceptable amount and of an unacceptable duration, then the sellers who are able to charge it constitute a relevant market unto themselves. In this sense "unilateral effects" analysis is very little different from conventional merger analysis.

In any event, these concerns stated by the *Oracle* court seem well taken:

Properly construed, *Brown Shoe* suggests merely that the technical definition of a relevant

²⁴ When a group of firms, if united by a cartel, could profitably exact a supracompetitive price increase of sufficient magnitude, that group is a relevant antitrust market. See ¶530a.

²⁵ *FTC v. Staples, Inc.*, 970 F. Supp. 1066, 1075 (D.D.C. 1997).

market in an antitrust case may be smaller than a layperson would normally consider to be a market. The use of the term “submarket” may be useful in “overcom[ing] the first blush or initial gut reaction” to a relatively narrowly defined market.²⁶

Focusing on “submarkets” may be misleading, however, because “the same proof which establishes the existence of a relevant product market also shows (or * * * fails to show) the existence of a product submarket: ... Defining a narrow “submarket” tends to require a relatively long laundry list of factors, which creates the danger of narrowing the market by factors that have little economic basis. Courts and commentators suggest that the use of the submarkets doctrine has, in fact, misled courts into “identify[ing] artificially narrow groupings of sales on the basis of noneconomic criteria having little to do with the ability to raise price above cost.”²⁷

The similarities between the submarkets doctrine generally and localized competition in unilateral effects cases are difficult to miss. Indeed, commentators have been quick to note the potential for “localized competition” analysis to devolve into an unstructured submarket-type analysis. ...²⁸

²⁶ *United States v. Oracle Corp.*, 331 F. Supp. 2d 1098, 1119 (N.D. Cal. 2004), citing *FTC v. Staples, Inc.*, 970 F. Supp. 1066, 1074 (D.D.C. 1997), which had defined the relevant market as “the sale of consumable office supplies through office supply superstores.”

²⁷ *Oracle*, 331 F.Supp.2d at 1119, citing and quoting *H.J. Inc. v. International Tel. & Tel. Corp.*, 867 F.2d 1531, 1540 (8th Cir. 1989), and ¶914a in the previous edition as well as *Allen-Myland, Inc. v. IBM*, 33 F.3d 194, 208 n.16 (3d Cir. 1994) cert. denied, 513 U.S. 1066 (1994); *Satellite Television & Associated Resources v. Continental Cablevision of Va., Inc.*, 714 F.2d 351, 355 n.5 (4th Cir. 1983) cert. denied, 465 U.S. 1027 (1984).

²⁸ *Oracle*, id., Citing 4 *Antitrust Law* ¶914a in the previous edition, as well as Roscoe B. Starek III & Stephen Stockum, What Makes Mergers

... Merely demonstrating that the merging parties' products are differentiated is not sufficient. Instead, a plaintiff must demonstrate product differentiation sufficient to sustain a small but significant and non-transitory price increase.

Even if a narrow market definition would be appropriate, it may be more difficult to identify "clear breaks in the chain of substitutes" sufficient to justify bright-line market boundaries in differentiated products unilateral effects cases. The conventional ideal market boundary divides products within the market, which are freely substitutable with one another, from products outside the market, which are poor substitutes for the products within the market. ... In differentiated products unilateral effects cases, a "spectrum" of product differences, inside and outside the market boundary, is more likely. ... In discussing unilateral effects, Shapiro has written:

[A]ny attempt to make a sharp distinction between products "in" and "out" of the market can be misleading if there is no clear break in the chain of substitutes: if products "in" the market are but distant substitutes for the merging products, their significance may be overstated by inclusion to the full extent that their market share would suggest; and if products "out" of the market have significant cross-elasticity with the merging products, their competitive significance may well be understated by their exclusion.²⁹

Anticompetitive?: "Unilateral Effects" Analysis Under the 1992 Merger Guidelines, 63 Antitrust L.J. 801, 814-815 (1995) (arguing that the Guidelines' focus on localized competition should not "be used as a tool for rehabilitating discredited 'submarket' analysis").

²⁹ Quoting and citing Carl Shapiro, Mergers with Differentiated Products, 10 Antitrust 23, 28 (Spring 1996); *United States v. Rockford Memorial Corp.*, 717 F. Supp. 1251, 1260 (N.D. Ill. 1989), aff'd, 898 F.2d 1278 (7th Cir. 1990) cert. denied, 498 U.S. 920 (1990); *Super Premium Ice Cream Distribution Antitrust Litig.*, 691 F. Supp. 1262 (N.D. Cal. 1988), aff'd sub nom. *Haagen-Dazs Co. v. Double Rainbow Gourmet Ice Creams, Inc.*, 895 F.2d 1417 (9th Cir. 1990) (table); and Edward Chamberlin, Product

Additionally, to the extent that clear breaks are difficult to identify, attempts to create defensible market boundaries are likely to be based on relatively vague product characteristics. Product characteristics that are too vague do not meet section 7's requirement that the relevant market be "well-defined."³⁰

In *Whole Foods* the D.C. Circuit "reluctantly" reversed the district court's refusal to issue a preliminary injunction against a contemplated merger between two natural food store chains in an alleged relevant product market of premium natural and organic supermarkets (PNOS).³¹ As the court described the procedural facts, the defendants had been rushing in order to comply with a financing timetable for the acquisition, and the FTC had therefore sought its preliminary injunction on "at best, poorly explained evidence."³²

The court first of all rejected the FTC's argument that minimized the importance of defining a relevant market in a unilateral effects case. In this case, market definition was central, but a price increase depended on the existence of a set of "core customers" who would prefer to pay higher prices rather than substitute to more general grocery chains. The smaller grouping of sales

Heterogeneity and Public Policy, 40 Am. Econ. Rev.(Papers & Procs.) 85, 86-87 (1950).

³⁰ *United States v. Oracle Corp.*, 331 F. Supp. 2d 1098, 1119-1121 (N.D. Cal. 2004).

³¹ *FTC v. Whole Foods Market, Inc.*, 548F.3d 1028(D.C. Cir. 2008). See also *United States v. Dairy Farmers of Am., Inc.*, 426 F.3d 850 (6th Cir. 2005) (disagreeing with the district court that lack of voting control of one merger partner by another precluded illegality); *United States v. Daily Gazette Co.*, 567 F.1 Supp. 2d 859 (S.D.W.Va. 2008) (fact that two newspapers had already been operating under an approved joint operating agreement did not serve to make their complete merger; under JOA many portions of the newspapers' business had continued to compete).

³² *Id.* at 1032.

accounted for by premium natural and organic supermarkets (“PNOS”) chains could be a relevant market even though numerous marginal customers would switch to more general grocers in response to a small but significant price increase:

The FTC's evidence delineated a PNOS submarket catering to a core group of customers who “have decided that natural and organic is important, lifestyle of health and ecological sustainability is important.”³³ It was undisputed that Whole Foods and Wild Oats provide higher levels of customer service than conventional supermarkets, a “unique environment,” and a particular focus on the “core values” these customers espoused. The FTC connected these intangible properties with concrete aspects of the PNOS model, such as a much larger selection of natural and organic products, FTC's Proposed Findings of Fact 13-14 & ¶ 66 (noting Earth Fare, a PNOS, carries “more than 45,000 natural and organic SKUs”) and a much greater concentration of perishables than conventional supermarkets, *id.* 14-15 & ¶ 69-70 (“Over 60% of Wild Oats' revenues” and “[n]early 70% of Whole Foods sales are natural or organic perishables.”)...³⁴

The court concluded that the district court erred in assuming that market definition “must depend on marginal consumers....”³⁵ The FTC had contended that the merging partners, Whole Foods and Wild Oats, were the two largest operators in the market for premium, natural, and organic supermarkets, which were stores that focused on high quality and particularly natural foods, targeting well educated and generally affluent customers. The FTC further alleged that under this market definition the merger would create monopolies in 18 cities where the two firms each had a store prior to the acquisition but had no rivals. The defendant, by contrast, claimed that the market must be

³³ Citing *Whole Foods*, 502 F.Supp.2d at 23.

³⁴ *Whole Foods*, 548 F.3d at 1040.

³⁵ *Ibid.*

defined more broadly to include other grocery chains who had and were continuing to expand rapidly into the natural foods business.

The court rejected the defendant's argument that it lacked jurisdiction because the case was moot, given that the merger was already completed and a certain amount of reorganization, including the sale of numerous stores, had already occurred. It noted numerous decisions holding that a remedy would be appropriate even after an acquisition had occurred. Further, the Supreme Court had proclaimed that divestiture is an appropriate remedy in a merger case – something that would be relevant only subsequent to a challenged acquisition.³⁶ In this case, where the merger had already occurred once the district court had declined to issue a preliminary injunction, the FTC would not be entitled to divestiture, but the court could preserve the existing status quo, perhaps by a hold separate order, or even restore the status quo ex ante.³⁷

Further, the district court had applied the correct legal standard for a request for a preliminary injunction by a government agency. The FTC did not need to show irreparable harm, and “private equities” alone could not override its showing of probable success on the merits.³⁸ Rather, the district court “must balance the likelihood of the FTC’s success against the equities, and the FTC could generally create a presumption favoring such relief by “rais[ing] questions going to the merits so serious, substantial, difficult[,] and doubtful as to make them fair ground for thorough investigation....”³⁹ The merging parties could rebut this presumption only by demonstrating “particularly strong equities” favoring the merging parties. In this case the district court had declined to balance any equities, a conclusion that must have

³⁶ *Id.* at 1033. *Ford Motor Co. v. United States*, 405 U.S. 562, 573 & n. 8 (1972); *United States v. Microsoft Corp.*, 253 F.3d 34, 105 (D.C.Cir. 2001) (en banc), cert. denied, 534 US 952 (2001), *on remand* 231 F. Supp. 2d 144 (D.D.C. 2002), *aff'd*, 373 F. 3d 1199 (D.C. Cir. 2004)

³⁷ *Ibid.*. The court additionally found as a factual matter that one of the reorganization or divestiture that had actually occurred would likely, if reversed, be tremendously upsetting to the firms. *Id.* at 874.

³⁸ *Id.* at 1035.

³⁹ *Ibid.*, quoting *Heinz*, 246 F.3d at 726.

rested on its conclusion that the FTC had failed to show a likelihood of success on the merits.⁴⁰

In addition, the district court had

observed that several supermarkets “have already repositioned themselves to compete vigorously with Whole Foods and Wild Oats for the consumers' premium natural and organic food business.” Thus, considering the defendants' evidence as well as the FTC's, as it was obligated to do, the court was in no doubt that this merger would not substantially lessen competition, because it found the evidence proved Whole Foods and Wild Oats compete among supermarkets generally. If, and only if, the district court's certainty was justified, it was appropriate for the court not to balance the likelihood of the FTC's success against the equities.⁴¹

But the circuit court disagreed with the district court on this issue. In this case the plaintiff's expert had predicted a post-merger price increase on the basis of estimates of demand elasticity that did not require market delineation in the traditional sense. However, the Supreme Court had interpreted the “any line of commerce” language in Section 7 of the Clayton Act to require a market definition.⁴² The court somewhat ambiguously suggested that market definition would not always be “crucial to the FTC's likelihood of success on the merits. Further, the analytical structure of defining a relevant market “does not exhaust the possible ways to prove a Section 7 violation on the merits.”⁴³ Nevertheless, a fair reading of the court's statement is that it was insisting on a market definition before a merger could be condemned in a proceeding on the merits, even if other types of evidence indicated the likelihood of a post-merger price increase.

In this case, however, the issue seemed irrelevant because the FTC had consistently proceeded on the assumption that a

⁴⁰ *Ibid.*

⁴¹ *Id.* at 1036.

⁴² *Id.* at 1037-1041. *Brown Shoe Co. v. United States*, 370 U.S. 294, 324 (1962).

⁴³ *Id.* at 1037.

market definition was necessary.⁴⁴ So the FTC's likelihood of success depended on the plausibility of its market definition, and this in turn depended on the extent to which customers would substitute away from the products sold by the two merging firms in response to a "small but significant and non-transitory increase in price" (SSNIP). Here, the defendant's expert had concluded that if the post-merger firm attempted to raise prices, "marginal" consumers – those whose loyalties to the natural food chains were relatively weak – would shift to more conventional supermarkets in significant numbers. Applying "critical loss analysis" the expert concluded that these substitutions would be sufficient to make such a price increase unprofitable.⁴⁵ In contrast, the FTC's expert rejected critical loss analysis and advocated a study of "diversion" ratios which considered "how many customers would be diverted to Whole Foods and how many to conventional supermarkets if a nearby Wild Oats closed." One important difference between these approaches was that the defendant's expert looked at the marginal loss of sales, while the plaintiff's expert looked at the average loss of customers.⁴⁶ Under the plaintiff's theory this use of averages was appropriate because there was a core of more committed, or inframarginal, customers who would remain loyal to the post-merger firm even in response to a significant price increase.⁴⁷ Thus the question whether a price increase would occur rested on a comparison of the losses that would result from the loss of marginal customers against the gains that would result from higher prices charged to the inframarginal customers.

The court noted that in at least some circumstances the ability to price discriminate would enable the firm to charge higher prices to inframarginal customers while yet competing for the business of

⁴⁴ *Ibid.*

⁴⁵ *Id.* at 1038.

⁴⁶ *Id.* at 1038-1039.

⁴⁷ The FTC identified these as a "core group" of customers had had "decided that natural and organic is important, lifestyle of health and ecological sustainability is important." See the district court opinion, *Whole Foods*, 502 F.Supp.2d at 223.

marginal customers.⁴⁸ However, it is difficult to see how a retail grocer could price discriminate between marginal and inframarginal customers, who typically would not even reveal their identities to the seller. Nevertheless, even in the absence of price discrimination possibility it might be the case that gains from the higher prices charged to inframarginal customers would more than offset losses resulting from the departure of marginal customers. That would be an empirical question. As the court observed:

In short, a core group of particularly dedicated, “distinct customers,” paying “distinct prices,” may constitute a recognizable submarket, *Brown Shoe*, 370 U.S. at 325, whether they are dedicated because they need a complete “cluster of products,” *Phila. Nat'l Bank*, 374 U.S. at 356, because their particular circumstances dictate that a product “is the only realistic choice,” *SuperTurf, Inc. v. Monsanto Co.*, 660 F.2d 1275, 1278 (8th Cir.1981), or because they find a particular product “uniquely attractive,” *Nat'l Collegiate Athletic Ass'n v. Bd. of Regents of the Univ. of Okla.*, 468 U.S. 85, 112 (1984). For example, the existence of core customers dedicated to office supply superstores, with their “unique combination of size, selection, depth [,] and breadth of inventory,” was an important factor distinguishing that submarket. *FTC v. Staples, Inc.*, 970 F.Supp. 1066, 1078-79 (D.D.C.1997).⁴⁹

While the court used “submarket” terminology, it should be clear that a relevant *market* is what it was talking about; that is, the relevant concern was that a significant group of customers existed who would rather pay a higher price than substitute to alternatives, all of which they found less satisfactory for one reason or another.

The court also cited the FTC's:

evidence of consumer behavior support[ing] the conclusion that PNOS serve a core consumer base. Whole Foods's internal projections, based on market experience, suggested

⁴⁸ *Id.* at 1040. *United States v. Rockford Mem'l Corp.*, 898 F.2d 1278, 1284 (7th Cir.1990); *Md. People's Counsel v. FERC*, 761 F.2d 780, 786-87 (D.C.Cir .1985).

⁴⁹ *Whole Foods*, 548F.3d at 1039.

that if a Wild Oats near a Whole Foods were to close, the majority (in some cases nearly all) of its customers would switch to the Whole Foods rather than to conventional supermarkets. Since Whole Foods's prices for perishables are higher than those of conventional supermarkets, such customers must not find shopping at the latter interchangeable with PNOS shopping. They are the core customers. Moreover, .68% of Whole Foods customers are core customers who share the Whole Foods "core values."⁵⁰

A dissenter complained that the majority was dealing far too leniently with the FTC's definition of the relevant product market.⁵¹ Among other things, the dissenter noted that the merger had already been consummated but prices had not increased, thus giving support to the claim that the natural food stores competed with larger general grocery chains:

In sum, while all supermarket retailers, including Whole Foods, attempt to differentiate themselves in some way in order to attract customers, they nevertheless compete, and compete vigorously, with each other. The evidence before the Court demonstrates that conventional or more traditional supermarkets today compete for the customers who shop at Whole Foods and Wild Oats, particularly the large number of cross-shopping customers-or customers at the margin-with a growing interest in natural and organic foods. Post-merger, all of these competing alternatives will remain.⁵²

Rather than showing a distinct market, the dissenter urged, the evidence showed no more than product differentiation, something which all grocers attempted to attain.⁵³ The dissent criticized the both the FTC and the majority for falling back on the term "submarkets" and falling back to the merger analysis of an earlier era.⁵⁴

⁵⁰ Id. at 1039.

⁵¹ Id. at 1051 (Kavanaugh, J., dissenting).

⁵² Id. at 1055.

⁵³ Ibid., citing 2B Antitrust Law ¶563 (previous edition).

⁵⁴ Id. at 1058, citing Brown Shoe Co. v. United States, 370 U.S. 294

Conclusion

In cases where a merger facilitates a significant “ unilateral” price increase for a grouping of sales that was not an obvious relevant market prior to the merger, the appropriate conclusion is that the merger has identified a new grouping of sales capable of being classified as a relevant market. This formulation meets the statutory requirement that the “effect” of a merger is anticompetitive in some “ line of commerce” and in some “ section of the country.” That is, §7’s “effect” usage invites consideration of the market’s structure *after* the merger rather than before, and if a new grouping of sales can be said to constitute a relevant market after the merger, that is an appropriate grouping for measuring the merger’s competitive impact.